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SUBJECT: BRAZILIAN FINANCE MINISTER FIRED, REPLACED BY BNDES
PRESIDENT GUIDO MANTEGA

REF: A) BRASILIA 604
B) BRASILIA 602
C) BRASILIA 546
D) HEARNE/OP CENTER TELCONS 3/27
E) PLOWMAN/TREASURY TELCONS 3/27

¶1. (SBU) Summary: President Lula fired Finance Minister Palocci the night of March 27 after evidence came to light implicating Palocci personally in the leak from state-owned bank Caixa Economica Federal (CEF) of the confidential bank statements of handyman Francenildo da Costa. Costa's bank statements, which showed some unusually large recent deposits, were leaked in an apparent effort to discredit his testimony to a Congressional Investigative Commission (CPI). Costa had stated that he had seen Palocci on several occasions at a Brasilia house allegedly used by several of the minister's aides as a base for illicit deals, influence peddling, and other shady activities (reftels).

¶2. (SBU) Lula named the President of the Social and Economic Development Bank (BNDES), Guido Mantega, to replace Palocci. Mantega, a former Minister of Planning who had butted heads with Palocci over interest rate policy and the prioritization of investment spending, opened his first full day on the job March 28 by affirming his commitment to economic policy continuity in morning television interview. Given Lula's desire to protect his biggest achievement -- the restoration of economic stability -- during this presidential election year, we believe he has turned to the loyal Mantega primarily as a caretaker figure. Nonetheless, while the short-term outlook is still stable, this appointment creates greater uncertainty about GOB policies into the longer term. Markets are greeting Mantega's appointment cautiously, particularly given the departure of much of Palocci's skilled team of technocrats, including Vice Minister Murilo Portugal and Treasury Secretary Levy.
End Summary.

Palocci Dismissed

¶3. (SBU) Brasilia watched raptly on March 27 as the soap opera-like Palocci saga entered one of its most dramatic episodes. The Federal Police took depositions from senior officials of state-owned bank Caixa Economica Federal (CEF), including its head, Jorge Mattoso, regarding the leak of a confidential bank information on the account activity of handyman Costa to weekly newsmagazine "Epoca" (ref A). The bank statements, which showed unusual large recent deposits, were leaked in an apparent attempt to discredit Costa's March 16 testimony to a congressional CPI. Costa had stated that he had seen Palocci on several occasions at a Brasilia house where several former Palocci aides are alleged have conducted illicit business deals (ref C). According to public accounts, Mattoso told the police that he personally gave a copy of Costa's bank statement to Palocci; Mattoso subsequently resigned. Both Palocci and Mattoso are potentially criminally liable for violating privacy laws in the leak case.

¶4. (SBU) Lula decided to fire Palocci after learning that he had been involved in the leak despite his protestations of innocence, both public and, reportedly, to Lula himself. Palocci initially tried to spin his departure as an amicable parting of ways, leading to some initial confusion as Palocci's resignation letter described events in ambiguous terms. The presidency later clarified that Palocci had been fired. (Comment: In a case not lacking in ironies, it appears that what finally sealed Palocci's fate was not the numerous allegations of corruption during his tenure as mayor of Riberao Preto, but rather Palocci's clumsy attempt to discredit his accusers. End Comment.)

Who is Mantega?

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¶5. (U) Lula named current BNDES President and former Planning Minister Guido Mantega to replace Palocci. The nomination will require Congressional confirmation. Mantega is an academic (economics undergraduate degree and Ph.D. in Sociology) who taught at the Catholic University of Sao Paulo. He is a PT party stalwart, Lula loyalist and long-time economic advisor to the president. He has written books on Brazil's economy. Current BNDES Vice President Demian Fiocca will replace Mantega as BNDES President.

¶6. (SBU) During his tenure as Planning Minister, as well as more recently as BNDES President, Mantega on occasion butted heads with Palocci over economic policy. He publicly criticized the high prevailing level of real interest rates and argued that achieving high primarily surpluses should not come at the cost of public investment spending. Nevertheless, Mantega sounded a note of continuity in his first interview the morning of March 28, stating that he would implement President Lula's economic policies. In that nationally televised interview, Mantega sidestepped pointed questions about his previous policy criticisms, noting simply that the Central Bank already is bringing interest rates down, a trend that should help deal with the problem of the strong Real (another Mantega pet peeve).

¶7. (SBU) Mantega's first order of business is to choose a Vice Minister, as Murilo Portugal also announced his departure March 27. Coupled with the April 1 departure of Treasury Secretary Joaquim Levy for a job at the IDB as well as that of Levy's assistant secretary, Antonio Gragnani, Mantega will have several key technical

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positions to fill. There is speculation that Mantega may ask some senior personnel from BNDES to join him at the Ministry, perhaps including Carlos Carvalho, a Citibank alum who currently is a BNDES director. Another possibility is that Finance Ministry Economic Policy Secretary (and PT party member) Bernard Appy would return to his previous job as Vice Minister.

Markets Cautious

18. (SBU) Markets have been reacting cautiously. After an initial depreciation of 2.7% at the opening of trading on March 27, the Real had stabilized, trading around 2.22 Reais per dollar as of mid-day. CSFB Chief Economist Nilson Teixeira told Econoff that his foreign clients are seeking to understand the import of the changes, but there are no signs of serious concern, either by domestic or foreign market actors. Teixeira's assessment was that Mantega would seek to maintain policy continuity in the short term. He worried that in the longer term, particularly in a potential second Lula term, the Finance Ministry would no longer play the role of stalwart defender of orthodox policies that Palocci had carved out for it.

19. (SBU) Comment: Lula's appointment of a loyalist to the Finance Ministry is likely aimed at protecting his biggest achievement, a healthy economy, in this presidential election year. On the fiscal side, while there may be increased pressures on the finance ministry to loosen spending, several institutional factors, including the fact that Congress has not yet passed the 2006 budget and that election-related spending limits kick in at the end of June, mean that the bureaucracy has even more limited ability than normal to spend quickly. On the monetary side, Lula is unlikely to countenance abrupt changes in policy which might destabilize nervous markets. Overall, Mantega's appointment will have bigger repercussions for policy in the longer term, particularly if Lula is reelected and keeps Mantega in that position. A key early sign of Mantega intentions will be his personnel choices.

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